



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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State Controller

CYNTHIA BRIDGES
Executive Director

May 24, 2013

Dear Interested Party:

Enclosed is the Third Discussion Paper on Regulation 1502, *Computers, Programs, and Data Processing*. Before the issue is presented at the Board's August 13, 2013 Business Taxes Committee meeting, staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, an interested parties meeting is scheduled as follows:

**June 5, 2013
Room 122 at 10:00 a.m.
450 N Street, Sacramento, CA**

If you would like to participate by teleconference, call 1-888-636-3807* and enter access code 499201. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at Susanne.Buehler@boe.ca.gov by June 19, 2013. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If you are interested in other Business Taxes Committee topics refer to our webpage at (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of discussion or issue papers, minutes, a procedures manual, and calendars arranged according to subject matter and by month.

Thank you for your consideration. We look forward to your comments and suggestions. Should you have any questions, please feel free to contact our Business Taxes Committee staff member Mr. Robert Wilke at 1-916-445-2137, who will be leading the meeting.

Sincerely,

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

SB:rsw

Enclosures

*The teleconference phone number was updated on May 30, 2013

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC:71)
Senator George Runner (Ret.), Member, Second District (via email)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)

Mr. David Hunter, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Sean Wallentine, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Alan Giorgi, Board Member's Office, Second District
Ms. Lynne Kinst, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Cynthia Bridges (MIC:73)
Mr. Randy Ferris (MIC:83)
Mr. Jeffrey L. McGuire (MIC:43)
Mr. Jeff Vest (MIC:85)
Mr. Jeff Angeja (MIC:85)
Mr. David Levine (MIC:85)
Mr. Robert Tucker (MIC:82)
Mr. Bradley Heller (MIC:82)
Ms. Crystal Yu (MIC:82)
Mr. Todd Gilman (MIC:70)
Ms. Laureen Simpson (MIC:70)
Mr. Bill Benson (MIC:67)
Mr. Joe Fitz (MIC:67)
Mr. Wayne Mashihara (MIC:46)
Mr. Kevin Hanks (MIC:49)
Mr. Bradley Miller (MIC:92)
Ms. Kirsten Stark (MIC:50)
Mr. Robert Wilke (MIC:50)

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Issues

1. Whether the Board should amend Regulation 1502, *Computers, Programs, and Data Processing*, to expressly clarify that when a consumer purchases a non-custom computer program (or software) via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional software maintenance contract that includes the transfer of a backup copy of the same or similar non-custom software recorded on tangible storage media, then tax does not apply to the charge for the non-custom software itself, and tax applies to 50 percent of the lump-sum charge for the optional software maintenance contract.
2. Whether the Board should amend Regulation 1502 to clarify whether and to what extent charges for “site licenses” to use non-custom software recorded on tangible storage media should be excluded from the measure of tax.

Background Regarding Issue 1 Pertaining to Backup Copies

During the Board’s discussion regarding the issue of whether to amend Regulation 1502, and/or amend Regulation 1507, *Technology Transfer Agreements*, at the January 15, 2013, Business Taxes Committee (BTC) meeting, the Board authorized staff to conduct additional, focused interested parties meetings on issues which, based on prior interested parties meetings, have the best potential for immediate resolution. One of those issues is potential amendments to Regulation 1502 to expressly clarify that when a consumer purchases non-custom software via an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional software maintenance contract that includes the transfer of a backup copy of the same or similar non-custom software recorded on tangible storage media, then tax does not apply to the charge for the non-custom software itself, and tax applies to 50 percent of the lump-sum charge for the optional software maintenance contract.

Current Regulation 1502

Regulation 1502 prescribes the application of tax to sales of non-custom software and maintenance contracts sold in connection with the sale or lease of non-custom software. Regulation 1502, subdivision (f)(1) explains that non-custom software may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which non-custom software has been recorded, coded, or punched. Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of non-custom software is not a taxable transaction if the software is “transferred [in an electronic download transaction] by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction.” Subdivision (f)(1)(D) also provides that the sale of non-custom software is not a taxable transaction if the software is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

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The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of software maintenance contracts. It provides that:

Maintenance contracts sold in connection with the sale or lease of [non-custom] computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which [non-custom] program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

Prior to January 1, 2003, all of the charges for optional software maintenance contracts were generally taxable because subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended subdivision (f)(1)(C), to read as follows:

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the [non-custom] software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a [non-custom] computer program or a maintenance contract.

The 2002 amendments recognized that optional software maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services and established the bright-line rule that only 50 percent of the lump-sum charge for an optional software maintenance contract is for the sale of taxable tangible personal property.

Need for Clarification Regarding Backup Copies

Board staff thought that some retailers were selling or leasing non-custom software via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional software maintenance contracts that entitle the customers to receive a backup copy of the same or similar non-custom software recorded on tangible storage media, which the customers may use to restore lost or corrupted data. Board staff thought that, in this particular situation, there may be some confusion as to:

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- Whether the charges for the non-custom software that was sold or leased in the electronic download or load-and-leave transaction qualify as nontaxable charges under Regulation 1502, subdivision (f)(1)(D) when customers also purchase such a software maintenance contract and are ultimately entitled to receive a backup copy of the same or similar non-custom software that the customers bought or leased in the electronic download or load-and-leave transaction that is recorded on tangible storage media; and
- Whether such a software maintenance contract can be properly characterized as “optional” so that only 50 percent of the lump-sum charge for the software maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

This is because the first paragraph of Regulation 1502, subdivision (f)(1)(C) specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which “improvements” and “error corrections” are recorded, and staff thought that some retailers were not sure whether such a backup copy is included in that reference. In addition, there are no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional software maintenance contracts, subject to tax at 50 percent of the lump-sum charge, that entitle customers to receive tangible storage media.

Staff’s Recommendation to Clarify the Treatment of Backup Copies

Staff believes that the 2002 amendments to Regulation 1502, subdivision (f)(1)(C) were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional software maintenance contract is taxable. In addition, staff believes that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), is intended to generally describe software maintenance contracts, not limit the types of tangible personal property that can be transferred under software maintenance contracts, including optional software maintenance contracts.

Furthermore, staff did not believe that the Board intended for optional software maintenance contracts to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of non-custom software, so that the purchaser may use the backup copy to restore lost or corrupted data from the original non-custom software to which the maintenance contract relates. And, staff did and still does not believe that the current provisions of Regulation 1502 are intended to prohibit the application of subdivision (f)(1)(C)’s provisions to optional software maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Therefore, Board staff proposed amendments to Regulation 1502, subdivision (f)(1)(C) to clarify that software maintenance contracts, including optional maintenance contracts, may include a backup copy of the same or similar non-custom software recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also proposed and still proposes amendments to Regulation 1502, subdivision (f)(1)(D) to clarify that subdivision (f)(1)(C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

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Interested Parties Comments

Board staff conducted an interested parties meeting to discuss the proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) on March 6, 2013. During the meeting, Mr. Mark Nebergall expressed his understanding that backup copies of non-custom software are simply used to restore non-custom software, rather than lost or corrupted data, as stated in staff's proposed amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that staff's proposed amendments to subdivision (f)(1)(C) be revised accordingly. Mr. Nebergall also expressed his understanding that it is not currently a common business practice for software retailers to provide a backup copy of non-custom software to their customers as part of an optional software maintenance agreement. Staff agreed to consider the requested revision to its proposed amendments and explained that the proposed amendments are intended to eliminate confusion regarding the treatment of backup copies of non-custom software under existing law and that the clarification may lead to changes in software retailers' current business practices.

Board staff also received written comments from Mr. Nebergall in a letter dated March 22, 2013, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the interested parties meeting, and indicated that the business community does not oppose staff's proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Mr. Nebergall also explained that:

Our concern with the approach set forth in the initial discussion paper is it *may* be at odds with the technology transfer agreement ("TTA") statutes, as construed by the recent decision in *Nortel*. . . . The court in *Nortel* held agreements for the sale of pre-written computer programs are eligible for the TTA exclusion. Our concern with the proposal set forth in the initial discussion paper has to do with cases where the both the underlying software and software maintenance are provided electronically or by load and leave and the backup copy of the underlying software is sold separately. By sold "separately," we mean the backup copy was sold at the same time as the software but appears as a separate item on the invoice or was sold at a later time. In our view, the TTA statutes would require that sales or use tax only be applied to the amount stated on the invoice for the backup copy. . . . [emphasis provided].

Staff agreed with Mr. Nebergall's suggested revision to staff's proposed amendments to Regulation 1502, subdivision (f)(1)(C), and has incorporated the revision into the proposed amendments to Regulation 1502 illustrated in Exhibit 1 to this discussion paper. Staff believes that consideration of the other comments regarding the application of the TTA statutes (Rev. & Tax Code, §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)), and the Court of Appeal's decision in *Nortel Networks, Inc., v. State Board of Equalization* (2011) 191 Cal.App.4th 1259 (hereafter, *Nortel*) are beyond the scope of the Regulation 1502-focused interested parties meetings the Board authorized in January 2013. However, the Board may authorize further discussions with interested parties focused on whether it is necessary to amend Regulation 1507 to clarify the application of the TTA statutes or *Nortel* when staff reports back to the Board in August 2013.

Although the backup copy issue is no longer the focus of the remaining interested parties

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meetings authorized in January 2013, staff still welcomes any comments and input from interested parties on the backup copy issue. Staff also remains open to informal discussions that might lead to a consensus regarding the application of the TTA statutes to sales of non-custom software recorded on tangible storage media.

Background Regarding Issue 2 Pertaining to Site Licenses

During the Board's discussion regarding the issue of whether to amend Regulation 1502, and/or amend Regulation 1507 at the January 15, 2013, BTC meeting, the Board also authorized staff to hold additional focused interested parties meetings to try to reach some consensus between industry and staff as to whether and to what extent charges for "site licenses" to use non-custom software recorded on tangible storage media should be excluded from the measure of tax; and if some consensus can be reached, discuss the text of amendments to Regulation 1502 that would further clarify the treatment of charges for "site licenses."

Current Regulation 1502

Neither the Sales and Use Tax Law nor Regulation 1502 define the term "site license." Regulation 1502, subdivision (f)(1)(A) and (B) currently provide as follows:

Tax applies to the sale or lease of the storage media or coding sheets on which or into which such [non-custom] (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

The first two sentences in paragraph (B) are intended to explain that tax applies to the entire amount charged to the customer for non-custom software recorded on tangible storage media, including charges for the increased use of the non-custom software, no matter how the consideration is characterized, and explain that when such consideration is characterized as

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license fees, then all the license fees, including license fees denoted as “site licenses” are subject to tax. However, the first two sentences in paragraph (B) do not appear to staff to be intended to tax consideration paid for copyright interests that are truly separate and distinct from the sale of non-custom software recorded on tangible storage media, as opposed to charges for the increased right to use the copyrighted software, as indicated by the third and fourth sentences in paragraph (B). That paragraph explains that tax does not apply to “license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right.”

Clarification of the “Site License” Issue

The Board’s Legal Department has historically concluded that site license fees which are paid so that a purchaser of non-custom software recorded on tangible storage media may make additional copies of the software and any other charges that are paid so that the purchaser obtains increased use of the non-custom software represent additional taxable consideration for the sale of the non-custom software, except when the third and fourth sentences of Regulation 1502, subdivision (f)(1)(B) apply. (See Sales and Use Tax Annotations 120.0528 (1/27/86) and 120.0552 (1/6/92).) Board staff has not determined that any amendments to Regulation 1502, subdivision (f)(1)(B) are necessary at this time because the subdivision is consistent with the Legal Department’s historical treatment of site licenses. Therefore, in order to fully address the site license issue, staff is first trying to determine whether there are any other circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) where there is a transfer of the right to reproduce or copy non-custom software to which a federal copyright attaches that is so separate and distinct from the sale of the non-custom software recorded on tangible storage media that the charges for the right to reproduce or copy should be exempt or excluded from tax. If staff determines that other circumstances do exist, then staff will work to clarify Regulation 1502 so that tax continues to apply to the entire amount charged to the customer for non-custom software recorded on tangible storage media, but does not apply to license fees for the transfer of copyrights that are sufficiently separate and distinct from non-custom software recorded on tangible storage media.

Terminology

Staff was not entirely sure that the term “site license” necessarily provided the correct nomenclature for this topic. This is because staff’s preliminary research indicated that the term “site license” generally referred to a license that allows multiple users to use the same software or copies of the same software at one location or site, and the discussion of the “site license” issue may include other licenses that are commonly sold to make and use multiple copies of the same software regardless of the location where the copies are used. Therefore, in the second discussion paper regarding proposed amendments to Regulation 1502, staff invited input from the interested parties as to whether they believed this issue should include a broader discussion of “license fees” paid for the right to reproduce or copy copyrighted software recorded on tangible storage media.

During the April 10, 2013, interested parties meeting, Mr. Nebergall indicated that the software industry continues to use the term “site license,” but that the term is now commonly understood

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to refer to licenses to make and use copies of the same software regardless of the location where the copies are used. In addition, staff received an April 25, 2013, letter from Mr. Nebergall, which he also sent on behalf of the California business community. (Exhibit 2.) The letter provides the following comments regarding the term “site license”:

As an initial threshold issue, we note that Regulation 1502 contains no definition of “site license” for prewritten computer programs and if the Regulation is to be amended to specially treat such licenses, a definition should be included as one of the amendments. The term “site license,” as currently used in the software industry, connotes a license that allows the customer to reproduce or copy the program for use by the customer, as opposed to a license that allows the customer to make copies and distribute or resell the copies to the public. The term “site license” is a holdover from the historical practice of licensing software to a customer for use at particular physical location or “site.”

The term “site license,” as used today, is not so restricted; it is used to describe a license that allows the customer to make a certain number of copies, or an unlimited number of copies, with or without limitation as to the physical location of where the copies may be used. In our view, the term “site license,” as currently understood in the industry, is any license of a prewritten computer program that allows the customer to make additional copies of the program for use on more than one computer. We suggest any amendments to Regulation 1502 that will specially treat licenses to reproduce prewritten computer programs for internal use by the customer include a definition along the lines outlined in this letter.

Based upon Mr. Nebergall’s comments, Board staff now believes that the term “site license” is useful for purposes of the current discussion regarding fees paid for the right to reproduce or copy copyrighted non-custom software recorded on tangible storage media for purposes of using the software, as opposed to fees paid for the right to reproduce or copy copyrighted non-custom software in order for the software to be published and distributed for a consideration to third parties. Board staff also agrees with Mr. Nebergall’s comment that if Regulation 1502 is amended to specifically address the application of tax to charges for “site licenses,” it would be helpful for the amendments to define the term.

In addition, Board staff believes that, for purposes of our current discussion, Mr. Nebergall’s April 25, 2013, letter provides two potential working definitions for the term “site license.” Mr. Nebergall’s letter states that the term site license, “as currently used in the software industry, connotes a license that allows the customer to reproduce or copy the program for use by the customer, as opposed to a license that allows the customer to make copies and distribute or resell the copies to the public.” It also provides that the term site license, “as currently understood in the industry, is any license of a [non-custom] computer program that allows the customer to make additional copies of the program for use on more than one computer.” Board staff currently thinks that the first potential definition is probably a better fit for the current discussion, than the second potential definition. However, staff is not necessarily certain that these are the only possible or potentially useful definitions for the term “site license.” Therefore, staff is not ready to agree to incorporate any specific definition for the term “site license” into Regulation 1502

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until Board staff agrees that it is necessary to clarify the application of tax to “site licenses” and staff can evaluate whether any specific definition for the term is consistent with and helps readers understand that clarification. As a result, staff is open to further discussions regarding how to best define the term “site license” for purposes of potential amendments to Regulation 1502 and invites further input from the interested parties.

Common Practice in the Industry

Board staff only has a limited understanding of the types of licenses that are commonly sold by software retailers and the fees that are commonly charged for such licenses from Board staff's experience as consumers and representing the agency as a consumer. Therefore, in the second discussion paper, Board staff also invited input regarding the scope of the various types of licenses that software retailers commonly sell in retailer-to-household consumer transactions and retailer-to-business consumer transactions involving the transfer of non-custom software recorded on tangible storage media, and, staff also indicated that we would appreciate any examples industry could provide. Staff believes that a better understanding of the software industry's common practices in this regard may help lead to a consensus as to whether there are any circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B), where charges for the right to reproduce or copy non-custom software recorded on tangible storage media are exempt or excluded from tax.

In his April 25, 2013, letter, Mr. Nebergall provided the following information in response to staff's request for input regarding the software industry's common software licensing practices:

With respect to copyrighted computer programs, the Copyright Act confers upon the *owner* of a copy rights to make certain copies for limited, specific purposes. The *owner* of a copy of a computer program is allowed another copy of the computer program, so long as the additional copy “is created as an additional step in the utilization of the computer program in conjunction with a machine and that is it used in or no other manner.” See 17 U.S.C. Sec. 117(a)(1). In addition, the Copyright Act permits the *owner* of a copy to make an additional copy for “archival purposes only.” See. 17 U.S.C. Sec. 117(a)(2). These rights are understood to allow the *owner* of a copy of a computer program to copy and install the program on the “hard drive” of a computer, and to allow the making of a an additional copy in the RAM of the computer so the computer can make use of the program. In addition, the *owner* of a copy may make a “back-up” copy of the program without infringing the copyright owner's exclusive rights.

These rights to make additional copies allowing the program to be used in a computer and for archival purposes are only conferred upon the “owner” of the copy of the program. However, it is not the practice in the software industry for the owners of the copyright in software to conduct transactions with customers that result in the customer becoming the “owner” of any copy of the program. The common method of transferring any rights in the program to the customer is through the use of an “end user license agreement” that conveys no ownership rights in the copy. At all times, the owner of the copyrights in the software retains

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ownership of any copies the possession of which might be transferred to the customer; title to the copy doesn't pass to the customer. This distinction is crucial: Without ownership of a copy of the computer program, the customer would receive no rights to make any copies that might be necessary to use the program on a computer, such as the right to make a copy from a storage disk onto the computer's hard drive, or from the hard drive to the RAM, or any archival copy. See *MAI Systems Corp. v. Peak Computer, Inc.*, 991 F.2d 511, fn. 5 (9th Cir. 1993).

It is the practice in the software industry, however, for the end user license agreement to expressly provide the customer with rights to make copies the same as, or similar to, the rights expressly afforded an owner of a copy under Section 117(a) of the Copyright Act; i.e., the right to make copies essential to the use of the software on a computer and/or an archival copy. We are unaware of any practice in the software industry where the purchaser of a software license would not receive sufficient rights to make the copies needed to install and run the software on a computer. A hypothetical possessor of a copy of a computer program unaccompanied by rights to make copies similar to those described in Section 117(a) of the Copyright Act likely would pay very little, if anything, for such a copy. Someone in possession of a copy of a computer program unaccompanied by a license to make copies essential for use of the program on a computer likely has possession of an infringing, illegal copy.

Applying this framework of copyright law to site licenses, it is readily apparent that the rights to make additional copies of the software and to use them on additional computers are rights specified under the Copyright Act. The right to make any additional copies clearly is encompassed by Section 106(1) of the Copyright Act. Someone who is not an owner of a copy of a computer program, absent an agreement with the copyright owner, does not receive any rights to make copies essential for use of the program in a computer and to make an archival copy, those rights also are rights reserved to the holder of the copyright under Section 106(1). Thus, site licenses convey significant intangible copyrights to the customer beyond those a simple owner of a copy would obtain by operation of Section 117(a) of the Copyright Act.

It also is clear from a technological standpoint, given the way computers operate, that it is essential for one to obtain the rights to make copies of the software in order to make use of the software. Thus, even with respect to single user licenses, the grant of the right to make copies essential for the use of the software on a computer goes to the very heart of the software license. The copyright aspects of any computer software license are the very essence of the transaction. Without the requisite right to make certain copies, the possessor of the copy of the software would be unable to use the software on a computer without committing copyright infringement.

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When a computer program is transferred to a licensee on a physical storage medium, and rights to make copies of the software are included with the license, the TTA statutes provide guidance on how to divide the sales price into the taxable part attributable to the storage medium and the nontaxable part attributable to the intangible copyright. Thus, attention must be paid to the application of the TTA statutes in any amendments to Reg. 1502 providing guidance with respect to the tax treatment of software site licenses.

[heading omitted]

It is common in the software industry for sellers of computer programs to permit licensees to copy to, install on and use licensed software on more than one computer, thus falling within the classic definition of a “site license.” For instance, an examination of the license terms for the copy of Microsoft “Word” used to prepare this letter reveals it is a site license because, in addition to allowing the installation and use of the copy on a desktop computer, it also allows the copying of the software and its installation on one additional portable device. A separate license is thus not needed to load another copy of the program onto a laptop computer.

Thus, site licenses are not restricted to customers who use software in a business. While many consumer software licenses also are site licenses, it is not common for consumer software licenses to allow the consumer to make more copies than are sufficient for personal, family or household use of the software. We believe it would be unusual for a consumer software license to permit the consumer to use software on more than five (5) computers. However, sometimes software licensed to a business will be single user licenses, and not permit the software to be used on more than a single computer. While the typical customer for a software site license is a business, frequently consumers purchase site licenses, and sometimes businesses purchase software that is a single user license. (*Italics in original.*)

Board staff appreciates the additional background information regarding the differences between the rights of an owner of a copy of copyrighted non-custom software recorded on tangible storage media and the rights of a person who is a licensee under the various types of licensing agreements the software industry employs. Board staff also appreciates the additional background information regarding some of the industry’s common types of licensing agreements.

Staff has found that Federal law recognizes that the “[o]wnership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied.” (17 U.S.C. § 202.) The additional information provided above, emphasizes that copyrighted software is a material object or product that consumers may only utilize in conjunction with a machine. It also highlights that federal copyright law recognizes that the owner of a copy of copyrighted software has the inherent right, as the owner of a material object in which a copyrighted work is embodied, to use its copy in conjunction with at least one machine, including making the additional copies that are necessary to use the software for its

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intended purpose, such as word processing, and making a backup copy, without infringing on the rights of the copyright holder. Therefore, Board staff believes that federal law's treatment of copies of copyrighted software confirms that the right to make some copies of copyrighted software so that it can be used for its intended purpose is part of the bundle of rights associated with the ownership of a copy of the software itself, and the owner of a copy is not required to obtain additional copyrights that are separate and distinct from the ownership of the copy just to use the software for its intended purpose. As a result, Board staff still thinks that, when a copy of copyrighted non-custom software is recorded on tangible storage media, Regulation 1502 correctly provides that tax applies to all of the charges for the copy.

Furthermore, Mr. Nebergall's April 25, 2013, letter, clarifies that "it is not the practice in the software industry for the owners of the copyright in software to conduct transactions with customers that result in the customer becoming the 'owner' of any copy of the program. The common method of transferring any rights in the program to the customer is through the use of an 'end user license agreement' that conveys no ownership rights in the copy." However, this fact does not lead staff to the same conclusions as Mr. Nebergall because Board staff understands that "where a transferee receives a particular copy of a copyrighted work pursuant to a written agreement, [the courts] consider all of the provisions of the agreement to determine whether the transferee became an owner of the copy or received a license." (*Vernor v. Autodesk, Inc.* (9th Cir. 2010) 621 F.3d 1102, 1109.) Therefore, whether a person is an owner or a licensee is dependent upon all the facts and circumstances of a particular transaction and staff does not necessarily believe it is fruitful to establish a bright-line rule based upon the principle that every consumer of copyrighted non-custom software will necessarily be a licensee.

Moreover, Board staff does not agree that Mr. Nebergall's April 25, 2013, letter describes all of the rights the owner of a copy of copyrighted non-custom software would have under all of the facts and circumstances of every potential situation. For example, the courts have applied the doctrines of implied license and equitable estoppel to prevent inequity in situations where the holder of a copyright has created an expectation that the customer may use a copy of a copyrighted work in specific ways, but does not actually grant the customer a license to make the copies essential to the anticipated use. (See, e.g., *Effects Associates, Inc. v. Cohen* (9th Cir. 1990) 908 F.2d 555, *Food Consulting Group, Inc. v. Azzalino* (9th Cir. 2001) 270 F.3d 821, footnote 10 [providing that "*Effects Associates* stands for the principle that a seller grants a buyer an implied license to use a product for the purpose for which the seller sold it to the buyer"], and *Hadady Corp. v. Dean Witter Reynolds, Inc.* (C.D. Cal. 1990) 739 F.Supp. 1392.) Also, federal law expressly provides broader rights to the owners of copies of copyrighted software than described in Mr. Nebergall's letter (see, e.g., 17 U.S.C. § 117), such as the right to sell the copy under specified circumstances. (17 U.S.C. § 117(b).)

In addition, federal law's treatment of an owner of a copy of copyrighted non-custom software, seems to indicate to staff, that, at a minimum, there cannot be a separate and distinct transfer of a copyright interest for sales and use tax purposes, unless the transferee actually receives more rights to copy copyrighted software than would be included in the bundle of rights held by an owner of that copy, who is not the copyright holder, under similar facts and circumstances. And, the information provided so far does not establish that the software industry's typical licensing

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agreements grant business or household consumers of non-custom software recorded on tangible storage media more rights than the owners of such copies would have absent such agreements.

As a result, Board staff does not believe that the information provided so far establishes that there are any other circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) where there is a transfer of the right to reproduce or copy copyrighted non-custom software that is so separate and distinct from the sale of the non-custom software recorded on tangible storage media that the charges for the right to reproduce or copy should be exempt or excluded from tax. However, staff is still open to exploring the issue further, including specific examples where the software industry believes that a licensee actually receives more rights to copy copyrighted software than would be included in the bundle of rights held by an owner of that copy under similar facts and circumstances.

Mr. Nebergall's Recent Proposals

Finally, Mr. Nebergall's April 25, 2013, letter ends by summarizing the business community's beliefs regarding site licenses and suggests two possible approaches to the treatment of site licenses, for sales and use tax purposes, that are more consistent with the business community's beliefs than the current provisions of Regulation 1502. The letter provides:

First, and to be clear, the business community believes, and has always believed, site licenses for computer programs, when sold on disk and where the price for the disk is separately stated in the agreement, have never been subject to sales and use tax because of their intangible nature. Such was the law before enactment of the TTA statutes or the decision in *Nortel Networks*. That part of the TTA statutes excluding from tax the amount separately stated in the TTA for the intangible property did not represent any change in the law, it represented merely a codification of existing law. Under California sales and use tax law, a reasonable amount separately stated in an agreement for the sale of intangible property is not subject to tax.

If the agreement between the licensor and the licensee separately states an amount for a tangible storage medium sold together with a site license, the taxable amount should be limited to the amount so separately stated, with the balance treated as non-taxable charges for intangible rights to make copies. Regulation 1502 should be amended to reflect this interplay with the TTA statutes.

When the agreement between the licensor and licensee does not separately state an amount for the tangible storage medium, current Regulation 1502(f)(1)(B) provides "tax applies to the entire amount charged to the customer." As applied to site licenses, this part of Regulation 1502 results in tax applying to nontaxable charges for intangible property as is at odds with both the basic law of California and the TTA statutes, which provide ways to separate the taxable and nontaxable components of a site license.

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There may be ways to amend Regulation 1502 to bring it closer [to] the basic law in California that sales of intangible property are not subject to tax and not damage the Board's litigating position post- *Nortel Networks*. Regulation 1502 already provides that sales of so-called "gold masters" are not subject to tax, with any storage medium treated as incidental Reg. 1502(f)(1)(B). A gold master differs from a site license with respect to the use to which the authorized copies of the software will be put. Under a gold master, the copies are to be resold or distributed to the public. Under a site license, the additional copies will be loaded on additional computers owned by the licensee and used instead of being resold.

One possible approach to the application of the sales and use tax to sales of site licenses would be to focus on the number of copies the license permits the licensee to make, and treat licenses permitting the making of a threshold number of copies as site licenses not subject to tax. If the license permitted the making of a number of copies below the threshold, the copyright interest would, as in the case of the treatment of gold masters with respect to the storage medium, be deemed "incidental," and ignored with the result tax would apply to the entire amount charged to the customer under the first sentence of Reg. 1502(f)(1)(B). While this approach would result in tax applying to charges for intangible rights to make copies of prewritten programs, it comes much closer to the basic law in California than the existing language in Regulation 1502.

Another possible approach to the issue simply would be to apply tax to the amount the licensor would charge for a single user license as fully taxable, with any additional amounts treated as charged for non-taxable intangible rights to make additional copies. This approach would be consistent with the Staff's position (with which we disagree) that software becomes tangible personal property when sold on a tangible storage medium, but also recognizes the interplay with the TTA statutes on how to divide a TTA into its taxable and nontaxable components when the seller makes separate sales of like tangible personal property without the intangible property. See Secs. 6011(c)(10)(B), 6012(c)(10)(B). Once again, while this approach would result in tax applying to charges for intangible rights to make copies of prewritten programs, it comes much closer to the basic law in California than the existing language in Regulation 1502. In either case, the seller should be allowed an election to treat the sale under the TTA statutes, thereby permitting alignment between a revised Regulation 1502 and the basic California law that charges for intangible property are not subject to sales or use tax.

Based upon staff's prior comments, Board staff is not ready to agree that there is necessarily a separate and distinct transfer of the right to reproduce or copy copyrighted non-custom software (i.e., separate and distinct from the sale of the non-custom software recorded on tangible storage media itself), merely because the customer receives more than a single-user license with the software.

Furthermore, it seems that consumers purchase software for their own use or other consumption

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in the common sense, and definitely not for resale. It also seems that there is broad recognition that some incidental copying is necessary for a consumer to use a copy of non-custom software recorded on tangible storage media in conjunction with any machine. And, the information provided thus far has not helped staff see how the true object of consumer software transactions shifts, even incrementally, from the use or other consumption of the software, to the obtainment of separate and distinct intellectual property rights, simply because the consumer can use the software in conjunction with more than one machine. For example, the information provided thus far has not provided a common-sense basis to distinguish a transaction that is structured so that the consumer gets one copy of non-custom software on tangible storage media and the right to use it on 10 machines from a transaction that is structured so that the consumer gets 10 copies of the same software recorded on tangible storage media to be used on one machine, each, because the true object of the transactions appears to be the same in both cases, that is the use or other consumption of non-custom software recorded on tangible storage media. Therefore, at this time, Board staff cannot agree that the information provided thus far necessarily establishes that there is a transfer of the right to reproduce or copy copyrighted non-custom software that is sufficiently separate and distinct from the sale of the non-custom software recorded on tangible storage media itself, merely because the customer receives the right to make more than a threshold number of copies of the software for its own use.

However, Board staff has not yet concluded that there are no other circumstances, which are not already described in Regulation 1502, subdivision (f)(1)(B) where there is a transfer of the right to reproduce or copy copyrighted non-custom software that is so separate and distinct from the sale of the non-custom software recorded on tangible storage media that the charges for the right to reproduce or copy should be exempt or excluded from tax, and staff looks forward to continuing to discuss and develop the issue.

Finally, as previously stated, staff believes that consideration of Mr. Nebergall's comments regarding the application of the TTA statutes, and the Court of Appeal's decision in *Nortel* are beyond the scope of the Regulation 1502-focused interested parties meetings the Board authorized in January 2013. However, the Board may authorize further discussions with interested parties focused on whether it is necessary to amend Regulation 1507 to clarify the application of the TTA statutes or *Nortel* when staff reports back to the Board in August 2013.

June Interested Parties Meeting

There is an interested parties meeting scheduled for June 5, 2013, to discuss the "site license" issue. During the meeting, Board staff will be prepared to discuss whatever additional information regarding copyrights and software licenses that industry provides. Board staff will also be prepared to discuss whether the Board should clarify its treatment of "site licenses."

If there appears to be a consensus between industry and staff regarding a need to change the Board's treatment of specific types of site licenses or site licenses generally during the interested parties meeting, then staff will begin to discuss specific amendments to Regulation 1502. Staff will also work on proposing specific amendments to Regulation 1502 to clarify the treatment of

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those licenses so that they can be included in the formal issue paper staff intends to prepare for the Board consideration at the August 13, 2013, BTC meeting.

Summary

Staff welcomes any comments, suggestions, and input from interested parties on the “site license” issue. Staff invites interested parties to participate in the June 5, 2013, meeting to discuss the issue of “site licenses” and the deadline for interested parties to provide written responses to this discussion paper is June 19, 2013. Currently, the June meeting is the last interested parties meetings scheduled to discuss the “site license” issue before it will be discussed, along with the related backup copy issue, at the August 13, 2013, BTC meeting.

Prepared by the Tax Policy Division, Sales and Use Tax Department, and Tax and Fee Programs Division, Legal Department

Current as of May 23, 2013

Regulation 1502. *Computers, Programs, and Data Processing.*

Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016, Revenue and Taxation Code.

(a) In General. "Automatic data processing services" are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as "data processing firms."

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. "Program" is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. "Subdivision" includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. "Problem" means and includes any problem that may be addressed or resolved by a program or subdivision; and the "problem" addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. "Problem" further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) Basic Applications of Tax.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property

(cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

(d) Manipulation of Customer-Furnished Information as Sale or Service.

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for data entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 "Mailing-Services.")

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) "Processing of customer-furnished information" means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) "Processing of customer-furnished information" does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to

typography, clip art combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media: inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if and), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) Computer Programs.

(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

(C) Maintenance contracts sold in connection with the sale or lease of a prewritten computer programs generally provide that the purchaser will be entitled to receive,

during the contract period, storage media on which ~~the~~ prewritten program improvements or error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

If the purchase of the maintenance contract is not optional with the purchaser, that is, if the purchaser must purchase the maintenance contract in order to purchase or lease a prewritten computer program, then the charges for the maintenance contract are taxable as part of the sale or lease of the prewritten program. Tax applies to any charge for consultation services provided in connection with a maintenance contract except as provided below.

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

(D) The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer, and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. Likewise, the sale of a prewritten program is not a taxable transaction if the program is installed by the seller on the customer's computer except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a "canned" or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

- (1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).
- (2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).
- (3) Consulting services (e.g., study of all or part of a data processing system).
- (4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).
- (5) Evaluation of bids (e.g., studies to determine which manufacturer's proposal for computer equipment would be most beneficial).
- (6) Providing technical help, analysts, and programmers, usually on an hourly basis.
- (7) Training Services.
- (8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)
- (9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm's billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, "Transportation Charges."

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or

her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)



April 25, 2013

Via Email

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department
State board of Equalization
450 N Street
Sacramento, California

**Re: Second Discussion Paper on Regulation 1502,
 Computers, Programs, and Data Processing-Site Licenses**

Dear Ms. Buehler:

This letter is the response of the California business community to your Second Discussion Paper on Regulation 1502, *Computers, Programs, and Data Processing* (the “discussion paper”). The issue presented in the discussion paper is whether the Board should amend Regulation 1502, to clarify whether and to what extent charges for “site licenses” to use prewritten software recorded on tangible storage media should be excluded from the measure of tax. The discussion paper makes no recommendation whether or to what extent sales of such software licenses are subject to tax. The California business community believes the Board should amend Regulation 1502 in this area, and we have suggestions for how sales of such software licenses might be treated under an amended regulation.

As we understand the issue paper, it is limited to sales of prewritten programs together with tangible personal property where the tangible personal property is an intermediate storage medium. Under the fact patten contemplated, the prewritten program will be copied from the intermediate storage medium onto a computer. The storage medium become irrelevant after the prewritten program is copied from the intermediate storage medium onto the computer. It is with this understanding that the following comments are to be construed.

We further understand the issue paper has no application to so-called "embedded" software where the tangible personal property with which the prewritten program is sold is something other than an intermediate storage medium; the tangible personal property has significance separate and apart from the computer program. These comments are not to be construed as having any application to software sold together with other tangible personal property such as a personal computer or any machinery controlled by computer software.

1. Definition of “Site License.”

As an initial threshold issue, we note that Regulation 1502 contains no definition of “site license” for prewritten computer programs and if the Regulation is to be amended to specially treat such licenses, a definition should be included as one of the amendments. The term “site license,” as currently used in the software industry, connotes a license that allows the customer to reproduce or copy the program for use by the customer, as opposed to a license that allows the customer to make copies and distribute or resell the copies to the public. The term “site license” is a holdover from the historical practice of licensing software to a customer for use at particular physical location or “site.”

The term “site license,” as used today, is not so restricted; it is used to describe a license that allows the customer to make a certain number of copies, or an unlimited number of copies, with or without limitation as to the physical location of where the copies may be used. In our view, the term “site license,” as currently understood in the industry, is any license of a prewritten computer program that allows the customer to make additional copies of the program for use on more than one computer. We suggest any amendments to Regulation 1502 that will specially treat licenses to reproduce prewritten computer programs for internal use by the customer include a definition along the lines outlined in this letter.

1. Copyright Act Overlay:

At the outset, it must be noted that in order for a computer to be able to make use of software, the preparation of copies of the software is essential. Given the way computers operate, a copy of the software to be used by the computer must be copied from an internal storage device, such as a hard disk drive, into temporary memory called “random access memory,” or “RAM.” Unless the owner of the computer has the legal right to make that temporary copy of the software from the disk drive to the RAM, the making of such a copy would constitute an infringement of the software developer’s copyright, exposing the infringer to statutory damages in amounts ranging from \$750 to \$30,000, plus attorneys’ fees. See 17 U.S.C. Secs. 501(a), 504(c). The owner of the copyright also could be entitled to injunctive relief. See 17 U.S.C. Sec. 502(a).

“Site licenses,” by definition, convey the right to make additional copies of prewritten compute programs. Therefore, the federal Copyright Act is implicated. The Copyright Act, with limited, specific exceptions, reserves to the owner of a copyright the “exclusive rights to do and authorize,” *inter alia*, the reproduction of the copyrighted work in copies. See 17 U.S.C. Sec. 106(1). In addition, it should be noted the Copyright Act makes clear the distinction between ownership of a copyright and ownership of any material object in which the copyrighted work is fixed. See 17 U.S.C. Sec. 202. Thus, transfer of ownership of a copy of a copyrighted computer program does not, in the absence of an agreement, transfer ownership of any of the exclusive rights, including the right to make copies, reserved to the owner of the copyright. *Id.*

With respect to copyrighted computer programs, the Copyright Act confers upon the *owner* of a copy rights to make certain copies for limited, specific purposes. The *owner* of a copy of a computer program is allowed another copy of the computer program, so long as the additional copy “is created as an additional step in the utilization of the computer program in conjunction with a machine and that it is used in or no other manner.” See 17 U.S.C. Sec. 117(a)(1). In addition, the Copyright Act permits the *owner* of a copy to make an additional copy for “archival purposes only.” See 17 U.S.C. Sec. 117(a)(2). These rights are understood to allow the *owner* of a copy of a computer program to copy and install the program on the “hard drive” of a computer, and to allow

the making of a an additional copy in the RAM of the computer so the computer can make use of the program. In addition, the *owner* of a copy may make a “back-up” copy of the program without infringing the copyright owner’s exclusive rights.

These rights to make additional copies allowing the program to be used in a computer and for archival purposes are only conferred upon the “owner” of the copy of the program. However, it is not the practice in the software industry for the owners of the copyright in software to conduct transactions with customers that result in the customer becoming the “owner” of any copy of the program. The common method of transferring any rights in the program to the customer is through the use of an “end user license agreement” that conveys no ownership rights in the copy. At all times, the owner of the copyrights in the software retains ownership of any copies the possession of which might be transferred to the customer; title to the copy doesn’t pass to the customer. This distinction is crucial: Without ownership of a copy of the computer program, the customer would receive no rights to make any copies that might be necessary to use the program on a computer, such as the right to make a copy from a storage disk onto the computer’s hard drive, or from the hard drive to the RAM, or any archival copy. See *MAI Systems Corp. v. Peak Computer, Inc.*, 991 F.2d 511, fn. 5 (9th Cir. 1993).

It is the practice in the software industry, however, for the end user license agreement to expressly provide the customer with rights to make copies the same as, or similar to, the rights expressly afforded an owner of a copy under Section 117(a) of the Copyright Act; i.e., the right to make copies essential to the use of the software on a computer and/or an archival copy. We are unaware of any practice in the software industry where the purchaser of a software license would not receive sufficient rights to make the copies needed to install and run the software on a computer. A hypothetical possessor of a copy of a computer program unaccompanied by rights to make copies similar to those described in Section 117(a) of the Copyright Act likely would pay very little, if anything, for such a copy. Someone in possession of a copy of a computer program unaccompanied by a license to make copies essential for use of the program on a computer likely has possession of an infringing, illegal copy.

Applying this framework of copyright law to site licenses, it is readily apparent that the rights to make additional copies of the software and to use them on additional computers are rights specified under the Copyright Act. The right to make any additional copies clearly is encompassed by Section 106(1) of the Copyright Act. Someone who is not an owner of a copy of a computer program, absent an agreement with the copyright owner, does not receive any rights to make copies essential for use of the program in a computer and to make an archival copy, those rights also are rights reserved to the holder of the copyright under Section 106(1). Thus, site licenses convey significant intangible copyrights to the customer beyond those a simple owner of a copy would obtain by operation of Section 117(a) of the Copyright Act.

It also is clear from a technological standpoint, given the way computers operate, that it is essential for one to obtain the rights to make copies of the software in order to make use of the software. Thus, even with respect to single user licenses, the grant of the right to make copies essential for the use of the software on a computer goes to the very heart of the software license. The copyright aspects of any computer software license are the very essence of the transaction. Without the requisite right to make certain copies, the possessor of the copy of the software would be unable to use the software on a computer without committing copyright infringement.

2. Interplay of Technology Transfer Agreement Provisions:

Because computer program site licenses convey significant copyrights to the customer, the Technology Transfer Agreement (“TTA”) provisions of the California sales and use tax statutes are implicated if a copy of the computer program is conveyed to the customer on a tangible storage media. The sales and use tax only applies to amounts charged for, or gross receipts from, sales of tangible personal property. Rev. and Tax Code Sec. 6011(a). The sales and use tax does not apply to amounts charged for, or gross receipts from, sales of intangible property transferred together with tangible personal property in a TTA. Secs. 6011(c)(10)(A), 6012(c)(10)(A). A TTA is any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest.” Secs. 6011(c)(10)(D), 6012(c)(10)(C).

In the recent case of *Nortel Networks Inc. vs. Board of Equalization*, 191 Cal.App.4th 1259 (2011), the Court of Appeals addressed a license to use computer software subject to a copyright interest of the licensor. The Court held such a software license could be a TTA. The amount paid for the intangible copyright transferred pursuant to a TTA was not subject to sales or use tax. As a result of the court’s decision in *Nortel Networks*, the Board repealed the part of Regulation 1507 excluding computer programs from the application of the TTA statutes.

When a computer program is transferred to a licensee on a physical storage medium, and rights to make copies of the software are included with the license, the TTA statutes provide guidance on how to divide the sales price into the taxable part attributable to the storage medium and the nontaxable part attributable to the intangible copyright. Thus, attention must be paid to the application of the TTA statutes in any amendments to Reg. 1502 providing guidance with respect to the tax treatment of software site licenses.

3. Prevalence of Site Licenses:

It is common in the software industry for sellers of computer programs to permit licensees to copy to, install on and use licensed software on more than one computer, thus falling within the classic definition of a “site license.” For instance, an examination of the license terms for the copy of Microsoft “Word” used to prepare this letter reveals it is a site license because, in addition to allowing the installation and use of the copy on a desktop computer, it also allows the copying of the software and its installation on one additional portable device. A separate license is thus not needed to load another copy of the program onto a laptop computer.

Thus, site licenses are not restricted to customers who use software in a business. While many consumer software licenses also are site licenses, it is not common for consumer software licenses to allow the consumer to make more copies than are sufficient for personal, family or household use of the software. We believe it would be unusual for a consumer software license to permit the consumer to use software on more than five (5) computers. However, sometimes software licensed to a business will be single user licenses, and not permit the software to be used on more than a single computer. While the typical customer for a software site license is a business, frequently consumers purchase site licenses, and sometimes businesses purchase software that is a single user license.

4. Possible Approaches to Sales Taxation of Site Licenses:

First, and to be clear, the business community believes, and has always believed, site licenses for computer programs, when sold on disk and where the price for the disk is separately stated in the agreement, have never been subject to sales and use tax because of their intangible nature. Such was the law before enactment of the TTA statutes or the decision in *Nortel Networks*. That part of the TTA statutes excluding from tax the amount separately stated in the TTA for the intangible property did not represent any change in the law, it represented merely a codification of existing law. Under California sales and use tax law, a reasonable amount separately stated in an agreement for the sale of intangible property is not subject to tax.

If the agreement between the licensor and the licensee separately states an amount for a tangible storage medium sold together with a site license, the taxable amount should be limited to the amount so separately stated, with the balance treated as non-taxable charges for intangible rights to make copies. Regulation 1502 should be amended to reflect this interplay with the TTA statutes.

When the agreement between the licensor and licensee does not separately state an amount for the tangible storage medium, current Regulation 1502(f)(1)(B) provides “tax applies to the entire amount charged to the customer.” As applied to site licenses, this part of Regulation 1502 results in tax applying to nontaxable charges for intangible property as is at odds with both the basic law of California and the TTA statutes, which provide ways to separate the taxable and nontaxable components of a site license.

There may be ways to amend Regulation 1502 to bring it closer the basic law in California that sales of intangible property are not subject to tax and not damage the Board’s litigating position post- *Nortel Networks*. Regulation 1502 already provides that sales of so-called “gold masters” are not subject to tax, with any storage medium treated as incidental Reg. 1502(f)(1)(B). A gold master differs from a site license with respect to the use to which the authorized copies of the software will be put. Under a gold master, the copies are to be resold or distributed to the public. Under a site license, the additional copies will be loaded on additional computers owned by the licensee and used instead of being resold.

One possible approach to the application of the sales and use tax to sales of site licenses would be to focus on the number of copies the license permits the licensee to make, and treat licenses permitting the making of a threshold number of copies as site licenses not subject to tax. If the license permitted the making of a number of copies below the threshold, the copyright interest would, as in the case of the treatment of gold masters with respect to the storage medium, be deemed “incidental,” and ignored with the result tax would apply to the entire amount charged to the customer under the first sentence of Reg. 1502(f)(1)(B). While this approach would result in tax applying to charges for intangible rights to make copies of prewritten programs, it comes much closer to the basic law in California than the existing language in Regulation 1502.

Another possible approach to the issue simply would be to apply tax to the amount the licensor would charge for a single user license as fully taxable, with any additional amounts treated as charged for non-taxable intangible rights to make additional copies. This approach would be consistent with the Staff’s position (with which we disagree) that software becomes tangible personal property when sold on a tangible storage medium, but also recognizes the interplay with the TTA statutes on how to divide a TTA into its taxable and nontaxable components when the seller makes separate sales of like tangible personal property without the intangible property. See Secs.

6011(c)(10)(B), 6012(c)(10)(B). Once again, while this approach would result in tax applying to charges for intangible rights to make copies of prewritten programs, it comes much closer to the basic law in California than the existing language in Regulation 1502.

In either case, the seller should be allowed an election to treat the sale under the TTA statutes, thereby permitting alignment between a revised Regulation 1502 and the basic California law that charges for intangible property are not subject to sales or use tax.

5. Conclusion:

We thank you for the opportunity to provide these comments, and hope you find them useful. If you have any questions or need further information, please contact the undersigned at (202) 486-3725 or mnebergall@softwarefinance.org.

Respectfully submitted,



Mark E. Nebergall
President
Software Finance & Tax Executives Council
On behalf of the California Business Community

CC: Randy Ferris
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